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American Council for Capital Formation
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SPECIAL REPORT

Bush Administration Focuses on U.S. Saving Rate

In late 1988, the American Council for Capital Formation Center for Policy Research launched a three-year "Project on Public Policy Options to Increase U.S. National Saving"—an intensive examination of the dangerously low U.S. saving rate, its economic consequences, and public policy options to reverse the situation. In October 1989, as part of this project, the Center sponsored a widely acclaimed two-and-one-half-day symposium, "Saving: The Challenge for the U.S. Economy," which brought together key policymakers from the administration and Congress, top academic economists, and business leaders for a discussion of this critical problem. A hardback volume consisting of updated versions of the conference papers, panelists' responses, and keynote addresses will appear this fall.

The ACCF Center for Policy Research therefore is pleased that a major section of the FY1991 federal budget proposed by President Bush—entitled "Increasing Saving, Investment and Productivity"—focuses on the urgent need to raise the U.S. saving rate. This Special Report *excerpts portions from that section of the FY 1991 budget.*

Importance of Saving

Without saving, the Bush administration observes in its 1991 budget, no resources would be available for investment. Someone must forego additional current consumption in order for investment plans to be realized. Ultimately, the rate of capital formation and the benefits that flow from more investment depend on the willingness to save. Saving and investment are linked by the cost of capital, which serves as a rationing mechanism to limit total investment to the resources made available by saving. In a closed economy, where investors are unable to borrow from abroad, a low saving rate is reflected in a high cost of capital. In an open economy, where domestic investors can borrow from foreign savers, domestic saving is no longer the sole constraint on investment.

The global integration of financial markets has cushioned U.S. domestic investment partially from the effects of a sharp decline in the domestic saving rate in the 1980s. Foreign capital inflows have helped to sustain U.S. economic growth. However, borrowing from abroad is a second-best solution in comparison with increasing domestic saving. When foreign savers provide capital, the future interest and dividend returns flow abroad rather than providing income for Americans.

Trends in U.S. Domestic Saving

Gross domestic saving averaged 16.5 percent of GNP during the 1960s and 1970s, and then fell by more than 2 percentage points to 14.1 percent in the 1980s (see Table 1). This decrease reflected both a widening of the federal budget deficit and a marked decline in personal saving. State and local governments ran surpluses and thus helped to cushion the decline in the gross domestic saving rate; this, however, was largely due to their growing pension fund reserves associated with future pension

Table 1: U.S. Gross Domestic Saving
(As Percent of GNP)

	Gross Domestic Saving	= Personal Saving	+ Business Saving	+ Federal Saving	+ State and Local Saving
1960–69	16.3	4.6	11.9	−0.3	—
1970–79	16.7	5.6	12.0	−1.7	0.8
1980–89	14.1	3.8	12.8	−3.8	1.3
1980–85	14.9	4.4	13.1	−3.9	1.3
1986	12.4	3.0	12.9	−4.9	1.5
1987	12.2	2.2	12.4	−3.6	1.1
1988	13.2	3.0	12.2	−3.0	1.0
1989: Q1–Q3	13.5	3.9	11.5	−2.8	0.9

Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 40.

liabilities. Gross business saving—the sum of undistributed corporate profits and business depreciation allowances—averaged 12.8 percent of GNP in the 1980s, slightly higher than in the prior two decades.

Net domestic saving, which deducts depreciation from gross saving, is considered by many experts to be a more accurate barometer of an economy's viability. This measure showed a proportionately greater decline than did gross saving, falling from an average of 8.2 percent of NNP (net national product) during the 1960s and 1970s to 3.4 percent in the 1980s (see Table 2). Two-thirds of this decline was due to the deepening federal deficit; the remainder was equally divided between a decline in personal and in business saving. Gross business saving has been sustained by the substantial increase in depreciation allowances due to the shift to short-lived capital goods. Net business saving—retained earnings—has been on a downtrend.

Personal Saving. In the 1980s, personal saving declined to a particularly low level despite favorable tax changes and high real interest rates, which should have encouraged saving. Personal saving fell by all official measures, decreasing from 7.0 percent of disposable income in the 1960s and 1970s to 5.4 percent in the 1980s, although the decline was greater as measured in the national income and product accounts (NIPA) than in the flow of funds accounts (FOF), which include purchases of consumer durables in their definition of personal saving (see Figure 1).[1]

In some ways, the 1980s offered a favorable climate for saving. The 1981 Economic Recovery Tax Act reduced taxes on saving by lowering marginal tax rates for the first time in almost two decades. The 1986 Tax Reform Act lowered the top marginal tax rate from 50 percent to 33 percent and phased out the tax deductions for most consumer interest expenses. Furthermore, real interest rates were high. These developments should have been conducive to a higher rate of personal saving.

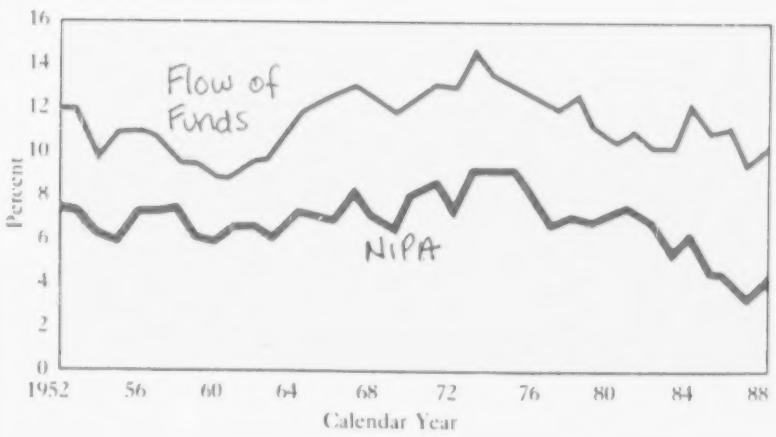
Other factors were evidently at work. In part, lower personal saving in the 1980s reflected a demographic phenomenon—the entrance of the

Table 2: **U.S. Net Domestic Saving**
(As Percent of NNP)

	Net Domestic Saving	= Personal Saving	+ Net Business Saving	+ Federal Saving	+ State and Local Saving
1960–69	8.6	5.1	3.8	−0.3	—
1970–79	7.9	6.2	2.7	−1.9	0.9
1980–89	3.4	4.3	1.9	−4.3	1.4
1980–85	4.0	5.0	1.9	−4.4	1.5
1986	1.7	3.3	2.2	−5.5	1.7
1987	1.7	2.5	1.9	−4.0	1.3
1988	2.9	3.3	1.8	−3.3	1.1
1989: Q1–Q3	3.3	4.3	1.1	−3.1	1.0

Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 40.

Figure 1: **U.S. Personal Saving Rates**
(As Percent of Disposable Income)



Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 42.

[1] Both measures of saving reflect new purchases of housing (housing purchases are classified as investment, not consumption, so they are automatically included in saving, which is defined in both sets of accounts as the difference between income and consumption). Neither measure of saving, however, reflects the revaluation of housing or other assets, so if existing houses become more valuable, the increase in wealth that this represents is not included in saving. In principle, asset revaluations should be reflected in the saving rate, but accurately measuring such capital gains presents practical difficulties.

baby-boom generation into the prime buying and borrowing phase of their lives. This increased the demand for cars and home appliances.

Another important reason for the decline in the personal saving rate was undoubtedly the increase in the value of household wealth. Since 1982, household financial assets have been substantially revalued by the surge in stock and bond prices. In the 1970s, and to a lesser extent in the 1980s, rising home prices had a similar effect on household wealth. Neither the NIPA nor the FOF saving measure takes account of the appreciation in asset values. But for individuals, higher prices for the assets they own, including their homes, are financially equivalent to new saving.

Employers' contributions to pensions are included in personal income and saving. Such contributions grew rapidly during the 1980s, partly because many private pensions were not adequately funded. Statutory changes required a higher degree of funding, which raised personal income, saving, and the saving rate. But in the 1980s, with the boom in stock prices, employers' contributions to pension plans were scaled back considerably, lowering the measured personal saving rate but adding to business saving.

Both the retirement income and the reduction in uncertainty provided by Social Security (which not only provides income during retirement, but also protects against both inflation and the "risk" of very long life) diminish the need for personal saving. On the other hand, to the extent that the Social Security program encourages people to plan an earlier retirement, it increases the incentive for personal saving. On balance, Social Security has probably reduced personal saving. Since there has been no corresponding increase in saving by the federal government, total domestic saving has probably been lower over the years than it would have been in the absence of Social Security, although the statistical evidence is not conclusive.

To the extent that demographic factors were responsible for the decline in personal saving in the 1980s, there is reason to expect that saving may recover somewhat in the 1990s. These should be high-earning years for the baby-boom generation as they enter their forties and fifties. If they follow the pattern of earlier generations, these will also be their high-saving years as they prepare for retirement in the next century. But relying on demographic developments alone to raise the saving rate would be unwise.

Federal Dissaving. The federal government has run a budget deficit for most of the past sixty years. In 1979, at the end of the business expansion of the late 1970s, the deficit had fallen to less than 2 percent of GNP. Over the next four years, it rose, reaching 6.3 percent of GNP in 1983. The deficit was pushed up initially by the two business recessions at the beginning of the decade, but when the economy began to recover, the deficit was slow to decline. In 1987 the deficit began to show a significant decline, and by 1989 it had dropped to just under 3 percent of GNP. But this still represents substantial federal dissaving, especially coming after a lengthy period of economic growth. Borrowing to finance the deficit, in effect, "uses up" part of the limited supply of private saving.

Federal dissaving, combined with the decline in private saving, has had significant economic consequences. High rates of interest kept the cost of capital high, diminishing domestic investment, slowing the growth of the capital stock, and, ultimately, lowering the future path of GNP. These effects have occurred despite a massive inflow of foreign saving (discussed below), though the importation of saving mitigated the effect on investment. With the need to expand potential capacity and to increase domestic saving so evident, federal deficit reduction is imperative.

Role of Foreign Saving in Maintaining U.S. Investment

The U.S. current account deficit widened from a small deficit of $7.0 billion in 1982 to a record deficit of $143.7 billion in 1987. It narrowed in the past two years, reaching an annual rate of $113.5 billion in the first three quarters of 1989. The counterpart to our current account deficit is a capital account surplus represented by foreign capital inflows, or foreign

Table 3: Sources of U.S. Net Investment
(As Percent of GNP)

	U.S. Net Domestic Saving	+	Inflow of Foreign Saving	=	Net Private Domestic Investment
1960–69	7.7		−0.6		7.1
1970–79	7.1		−0.2		6.8
1980–89	3.0		1.6		4.6
1980–85	3.6		0.9		4.5
1986	1.5		3.2		4.7
1987	1.4		3.3		4.7
1988	2.4		2.4		4.9
1989: Q1–Q3	2.5		1.9		4.4

Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 43.

investment in the United States.

International capital markets channel resources from countries with excess domestic saving over investment (e.g., Japan) to those where domestic saving is low relative to domestic investment. Given the sharp decline in U.S. net domestic saving, private investment would have fallen much more than it did if capital had not flowed in from abroad (see Table 3).

Although it is possible for a country to run a current account deficit for as long as foreigners are willing to add to their net holdings of its assets, there is a tendency over time for such imbalances to be corrected. Eventually, the United States' reliance on foreign capital will decline. When that happens, the United States will have to increase its export earnings to service the capital it has borrowed abroad. During the transition to a higher level of net exports, either consumption or domestic investment will have to grow more slowly than total national output. The best way to manage this transition would be to increase domestic saving by both government and the private sector. That would have the advantage of cushioning domestic investment while voluntarily slowing the growth of consumption.

Table 4: Net Saving Rates by Sector, 1980–87
(Net Saving as Percent of Net National Income)

	Total	Government*	Households	Enterprises
Japan	20.3	4.1	13.5	2.7
Italy	12.8	N.A.	N.A.	N.A.
Germany	10.8	1.4	8.9	0.5
Canada	9.9	−3.9	9.7	4.1
France	8.6	N.A.	N.A.	N.A.
United Kingdom	6.3	−1.6	5.0	3.4
United States	4.2	−3.9	6.2	2.0
U.S. ranking	7/7	4/5	4/5	4/5

Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 44.
*Includes some public physical capital investment as saving. N.A.: Not available.

Table 5: Personal Saving Rates: 1981–86
(As Percent of Disposable Income)

	Gross Saving	Including Consumer Durables	Including Saving of Social Security	Adjusted for Private Pensions, Life Insurance	Including Inflation Gains or Losses
United States	13.2	22.5	12.8	7.8	9.9
Italy	24.4	31.9	24.7	23.3	12.0
Japan	21.6	26.1	24.6	18.3	19.7
Canada	18.7	30.1	19.6	14.0	13.9
France	15.6	22.7	16.1	14.6	12.0
Finland	12.1	21.5	12.0	N.A.	N.A.
United Kingdom	10.7	19.2	10.7	2.7	8.4
Sweden	6.3	14.8	10.8	4.3	N.A.
U.S. ranking	5/8	5/8	5/8	5/7	5/6

Source: Budget of the United States Government, Fiscal Year 1991 (Washington, D.C.: U.S. Government Printing Office, January 1990), p. 44.
N.A.: Not available.

International Saving Comparisons

The U.S. national saving rate has ranked near the bottom among the major industrial countries throughout the postwar period (see Table 4). The rate of general government saving in the United States also ranks low. Personal saving is considerably lower than in other countries, even after adjustments are made for differences in definition (see Table 5). The gap is particularly wide when comparing U.S. saving rates—both the national rate and the personal rate—with those of Japan and Germany.

In the international system of national accounts on which these comparisons are based, some public physical capital formation is treated as saving. This is especially important in the comparison between the United States and Japan. The Japanese government invests approximately 6.7 percent of Japanese GNP in public nonmilitary capital. The United States invests only about 2.1 percent of GNP.

If the comparisons were made using the United States' national income definitions, which exclude public capital formation from net saving, the United States and Japanese saving rates would be much closer. Indeed, if the Japanese had measured depreciation as the United States does, the two countries' net saving rates would have approached one another in the late 1970s. Nonetheless, even on this basis, a large difference between the United States and the Japanese saving rates persisted throughout the 1980s due to the higher personal saving of Japanese households and the widening of the U.S. government's budget deficit at time when the Japanese budget deficit was declining (see Table 5).

Although the gap between U.S. and foreign private saving rates cannot be fully explained, several features of our tax code make saving more costly and borrowing cheaper in the United States. The U.S. statutory capital gains tax rate is higher than that of the other industrial countries, with the exception of Australia and the United Kingdom, both of which, however, index long-term capital gains. Indexing reduces the effective tax rate on real capital gains compared with the United States.

Interest income is fully taxed in the United States, and dividends from equity holdings are taxed at both the individual and the corporate level, a less advantageous treatment than is typically available elsewhere. For example, Japan has historically allowed most interest income to escape taxation.

It is instructive to compare the U.S. saving rate with that of Canada because the two countries are closely linked geographically, economically, and culturally. For most of the postwar period, the rate of household saving in Canada fell short of that in the United States, but in the 1980s it leaped ahead when significant differences emerged in the way the two countries tax saving. Canada indexes capital gains before taxes, which effectively lowers the rate of tax on real capital gains compared to the United States. Moreover, since the early 1970s, Canada has allowed even more generous tax deductions for retirement saving plans than the deductible IRA plan that was in effect between 1982 and 1986 in the United States. The shift in the two countries' relative saving behavior began at about the time when Canada introduced these new saving vehicles.

Policy Prescriptions

The administration's legislative initiative consists of three parts: a Family Savings Account, capital gains tax reductions, and a home ownership initiative. The revenue effects of these proposals are shown in Table 6.

Table 6: Revenue Effects of The Savings and Economic Growth Act, FY 1990 to FY 1995
(billions of dollars)

	Fiscal Years						
	1990	1991	1992	1993	1994	1995	1990–1995
Family savings account	*	−0.2	−0.6	−1.0	−1.3	−1.6	−4.7
Capital gains tax rate reduction	0.5	4.9	2.8	1.2	1.7	1.4	12.5
Penalty-free IRA withdrawals for first-time home buyers	−*	−*	−0.1	−0.1	−0.1	−0.1	−0.4
Total	0.5	4.7	2.1	0.1	0.3	−0.3	7.4

Source: General Explanations of the President's Budget Proposals Affecting Receipts (Washington, D.C.: Department of the Treasury, January 1990), pp. 10, 13, and 16.
* Revenue loss of less than $50 million.

- ***Family Savings Account***

A new Family Savings Account (FSA) is proposed to give most Americans an opportunity to save through a simple and understandable tax-free savings incentive program. The Family Savings Account differs from a deductible current-law IRA in two respects: (1) the contributions are not deductible, but (2) if the account is maintained for at least seven years, neither the contributions nor the earnings are taxed when withdrawn. As in the case of IRAs, the income would not be taxed when earned in the FSA. The proposal would allow individuals (other than dependents) to make nondeductible contributions to a FSA of the lesser of $2,500 or the individual's compensation for the year. Contributions would be allowed for single filers with adjusted gross income (AGI) less than $60,000, for heads of households with AGI less than $100,000, and for married taxpayers filing joint returns with AGI less than $120,000. Contributions to FSAs would be allowed in addition to contributions to current-law qualified pension plans, IRAs, 401(k) plans, and other tax-favored forms of saving.

Earnings on contributions retained in the FSA for at least seven years would be eligible for full tax exemption upon withdrawal. However, withdrawals of earnings allocable to contributions retained in the FSA for less than three years would be subject to both a 10 percent excise tax penalty and to income tax. Withdrawals of earnings allocable to contributions retained in the FSA for three to seven years would be subject only to income tax. The effective date would be January 1, 1990.

- ***Capital Gains Tax Reductions***

Under current law, capital gains of individuals are taxed at the same rates as ordinary income. Capital gains are thus generally subject to a 15 percent, 28 percent, or 33 percent marginal tax rate. When capital gains taxes interact with other provisions in the income tax code, such as the floors under itemized deductions for medical and miscellaneous expenses, the phase-out of IRA deductions, and the exclusion of Social Security income, the marginal tax cost of an asset may be even higher in some cases.